NAEPC
Journal of Estate & Tax Planning
COLLABORATE • EDUCATE • CULTIVATE

Click here to view Issue 40

COMMITTEE REPORT:
INSURANCE

By **Charles L. Ratner**

A Boomer at the Crossroads Of a Vintage Policy

When weaving the options, tax planning should loom large

A hypothetical policyholder is about to get on a call with just as hypothetical an insurance advisor. They're going to discuss the options that the policyholder has for a now-vintage life insurance policy that he bought "when he was a kid." We'll refer to the policyholder, both individually and generically, as Charlie or "C," just to show that there are no bounds to my creativity. We'll refer to the advisor as "A," for the same reason.

The genesis for the call is that Charlie has finally gotten around to a New Year's resolution (he won't say from what year) to work with his wife to consolidate and simplify their finances. He's about to be pleasantly surprised, albeit a little confused, by all the options he has for the policy. He's also about to find that each and every one of those options involves a learning curve and some trade-offs along the way to an informed decision.

Stipulations

Before we listen in on the conversation, let's stipulate a couple of things. First, any given insurance professional could conduct this conversation differently from the way this advisor will conduct it, perhaps exploring what I'll refer to as "options within the options" that are beyond the scope of this article. And that's fine. The important thing is that the conversation occurs in the first place! Second, life insurance professionals know that the conversation with Charlie would quickly take a different tack to the extent that any of his circumstances, mindset or policy type and condition differ from those in the article. That's why the point of this article is to make five larger points:

1. A vintage, well-funded cash value policy of any stripe can be an exceedingly valuable asset, especially these days.
2. Unless they're remarkably well read for someone not in the insurance business, the typical insured/policyholder doesn't know what they don't know about the policy or the breadth of options for dealing with it. That lack of knowledge could lead to an unfortunate decision that can't be undone.
3. It would be a mistake to think that this kind of interaction between a policyholder and an advisor is just about life insurance policy mechanics and underwriting. It's also an exercise in broad-based personal financial planning and, as always, tax planning. In fact, at this stage in Charlie's life, meaning the financial de-accumulation stage, tax planning is as important and as complicated as it's ever been. Therefore, the tax implications of the options that the advisor will discuss are of paramount importance.
4. It takes a true professional to ask the right questions, gather the right information about both the insured and the policy, listen carefully to really "hear" the individual, see the whole field and not just the goal posts, fashion the right recommendations and create a glide path for informed decisions. Actually, isn't this last point the quintessence of counseling, perhaps any form of counseling?
5. Speaking of tax planning, the insurance advisor isn't the only type of advisor who could add value by broaching this topic with a client. The topic lends itself nicely to being a part of what Charlie refers to

Charles L. Ratner, based in Cleveland, is a member of the *Trusts & Estates* Editorial Advisory Board

later on as a "tax tune-up." It's a great opportunity for collaborative work among advisors.

With that, as duly authorized eavesdroppers, let's listen in to some of the more interesting parts of the conversation. And by the way, I phrased some of Charlie's questions and remarks to reflect the fact that he's a consumer, asking the kind of questions and making the kind of remarks that an insurance professional would expect from a consumer in a wide-ranging conversation like this one. Charlie won't always make sense, but he's learning!

Let's Start With Some Background

A: While we wait for the policy statement and in-force illustration, I have a few questions for background. When did you buy the policy, and what was your underwriting classification?

C: I bought it a little more than 40 years ago. Whatever the best underwriting class was, that's what I got.

A: Just to confirm, do you own the policy, or is it in a trust?

C: I own it. My wife is the primary beneficiary and a trust is secondary.

A: Just curious, why did you buy the policy?

C: I was newly married, we were buying a house and I wanted some life insurance. I bought some term insurance, which is long gone now. But I also bought this policy because it combined the insurance with a systematic way to save that I knew I would stick with. As I look back now, it was one of the smartest things I ever did!

A: You mean buying the policy?

C: No, I mean getting married! But the policy was a smart move too.

Fast Forward to Today

A: What role does the policy now play in your planning? Do you still need the coverage, and even if you don't need it, do you still like to know it's there?

C: I suppose that "technically," meaning if I were to run the numbers, I'd see that I don't need the coverage. But it definitely gives me some peace of mind, just in case. So, yeah, I like knowing it's there. But there's more to it than that. I see the markets are taking a hit today, which is no big deal, but it does remind me how I've always liked the way my cash value grows, regardless of what's happening in the markets. I've always liked that the build-up isn't taxed and, of course, the fact that my wife won't pay taxes on the insurance proceeds is also obviously a big plus. Bottom line, the policy's been a great anchor to windward, I mean, if you get my drift.

A: Are you still paying premiums?

C: Yes and using the dividends to buy paid-up additions. The dividends have exceeded the premium for several years now. In fact, this year's dividend should be at least three times greater than the premium. At least! But I've kept up the premiums, even though the policy should be able to support itself for the duration. Right?

> One variation is where you have the annual dividend pay the premium with the excess dividend paid to you in cash.

A: Yes, that should be right, but we'll take a closer look when we get the illustration and talk about your options.

A: Approximately how much cash value and how much death benefit?

C: According to my last statement, the cash value is \$X, and the death benefit is \$1.5X.

A: Do you know what your basis is in the policy, meaning how much premium you've paid?

C: I think it's around \$.5X.

A: Any policy loan?

C: No.

A: Hey, I see we got the in-force illustration, along with a couple of others. It assumes that you continue to pay premiums and apply the dividends to paid-up additions. This is a nice policy! See how the cash value and death benefit keep rising? We'll use this illustration as our base case. Just a few more questions.

A: The premium is around $750 a year. Is the $750 a burden for you?

C: No. We're cutting back here and there because, you know. But, no, it's not a burden. I don't really even notice it anymore.

A: Are you as healthy as you look?

C: Hey, you're not supposed to be able to see me because this is only a telephone call. But, I'm a healthy 72 year old, today anyway. And a non-smoker, by the way.

A: Assuming on a very preliminary basis, meaning that based on a couple of assumptions it looked like an exchange would have merit, would you then be willing to share your medical information so I could get a more realistic sense of what could be available?

> Newer policies can have some guardrails that mitigate the risk of a policy's lapsing.

C: I guess so. Hey, maybe you could just have someone drive by the house, and I'd look out and wave. Sorry, yeah, I'm okay with sharing that information if, as you say, I can see there's a reason to do that.

A: Do you have long-term care (LTC) insurance?

C: No. Why do you ask?

A: Because one of the options we'll talk about involves exchanging your policy for one that can provide LTC benefits.

C: I think I'm gonna need a bigger notepad!

A: Are you a tax-sensitive investor?

C: Is there any other kind? But seriously, I do take taxes into account as an investor, which is why I appreciate that they don't tax the growth in cash value in my policy. In fact, I'm probably more tax sensitive and more tax aware these days than I ever was, especially after our tax advisor gave us a tutorial about planning for stuff like required minimum distributions, the net investment income tax and the Medicare surtax. Let's just say that she got our attention! So I do have to be sensitive to the tax implications of any move I make with the policy.

Financial Priorities

A: One more question so that I can try to laser focus the discussion. Do you have any other financial priorities or concerns that I should know about before we get into your options for the policy?

C: How much time you got? Actually, we're trying to declutter. We're consolidating our accounts, trying to automate things where we can, challenging the reasons for owning this or that and, basically, trying to simplify and streamline our finances and reduce the number of things we have to keep track of ourselves. Should have done it a few years ago when we retired but, you know. Beyond that, I'm sure that I have a lot of the same concerns that many people you talk to have. In a nutshell, it's whether our money will last at least as long as we do. Some days I feel pretty confident that we're okay. But some other days, I have my doubts. Anyway, that's part of why we're taking a hard look at our investments and all that.

A: I know you didn't mention any concern about legacy or estate taxes, but I should ask just to be thorough.

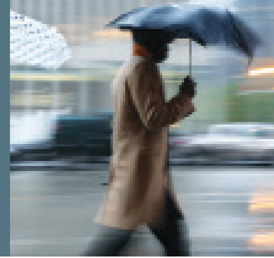
C: Understood. No, we're not concerned about that.

Options

A: Okay, let's go through your options. By the way, I encourage you to run any and all of this by your tax advisor or any advisor that you would like to consult with. Your advisor can call me with any questions or requests for material.

Stay the course. The first option is to stay the course. Give or take a change in the dividend scale, this is how your policy will look in the future if you continue to pay the premiums. I'm glad to see that they included columns for the internal rates of return for the cash value and death benefit, respectively. A lot of people find those columns help them measure the bang for the buck they're getting from the policy under different scenarios. Here are some variations on the theme:

Apply dividends to premiums, excess to paid-up



additions. In this illustration, you've changed the dividend option to "dividends to reduce, balance to additions," which means that the dividend is first applied to the premium and the excess dividend buys paid-up additions. No more cash outlay, but you still have all the cash value and insurance coverage. In fact, both continue to increase, just not as rapidly as they would under the base case.

C: Not bad! No more premiums, my capital is intact and I keep the coverage. And the cash value and insurance even increase. I like this!

A: Great. Here's another variation:

Apply dividend to premiums, excess paid in cash. The next variation is where you have the annual dividend pay the premium, with the excess dividend paid to you in cash. So you not only have no further outlay, but also you have an income stream. As a tax-sensitive individual, you'll like that the income stream will be tax free and won't bump up your Medicare income base until you've recovered your basis, which is projected to take 11 years. After that, it's taxable.

C: I like this one too! But now I'm starting to see the trade-offs. Would I rather see the insurance growing or get a check every year that I could invest, maybe help to pay Medicare premiums or just apply to the pursuit of happiness? Anyway, as I look at the first two illustrations and see how the dividends aren't buying a lot of insurance as I get older, it's obvious that there's no obvious conclusion. I'm going to have to run some numbers to figure out where I get the most bang for the buck. Actually, who am I kidding? I can run numbers until the Titanic arrives in New York. It will all depend on the assumptions, and who knows if they're any good. Anyway, I have

TAILORED SOLUTIONS FOR A FULFILLING FUTURE

That's the kind of service you can expect from NFP Insurance Solutions.

Nothing worth doing is ever going to be easy — but you don't have to go at it alone.

At NFP Insurance Solutions, we're experts in planning for high net worth individuals, families and businesses in:

- Estates
- Personal Insurance
- Disability
- Long-Term Care
- Annuities
- Life Insurance

...and a whole lot more.

Make some time for your future today. Call us at **312-683-7152** and find us online at **sbsisolutions.com**

Howard E. Sharfman
Senior Managing Director

500 West Madison Street | 32nd Floor | Chicago, IL 60661
P: 312.683.7152 | F: 312.759.4452 | M: 312.927.6343
howard.sharfman@nfp.com | sbsisolutions.com

Securities may be offered through Kestra Investment Services, LLC (Kestra IS), member FINRA/SIPC. Investment Advisory Services may be offered through Kestra Advisory Services, LLC (Kestra AS). NFP Insurance Solutions is a marketing name and platform used by affiliated and non affiliated companies, including but not limited to SBSI, Inc., using the services of NFP Insurance Services, Inc (NFPISI), a subsidiary of NFP Corp. PartnersFinancial is a division of NFPISI. Kestra IS and Kestra AS are not affiliated with SBSI, Inc. or NFP Corp. Kestra IS, Kestra AS, and NFP Corp. and its subsidiaries do not provide tax or legal advice and are not Certified Public Accounting (CPA) firms.
Investor Disclosures - https://bit.ly/KF-Disclosures

a strong sense that the decision won't depend on the numbers, at least not on the numbers alone.

A: By the way, just so I don't forget, I should mention that you could just surrender the policy for its cash value. The difference between the cash value and the premiums you paid would be ordinary income.

C: Ordinary income? Ouch! I don't want to go there. Anyway, I don't want to lose the policy.

If you prioritize the death benefit for your survivors over the cash value for your own use, a 1035 exchange might enable you to apply the cash value of the current policy as premium for a new policy with a considerably larger death benefit.

A: **Tap policy for more income**. The next variation would be of interest if you want to start tapping the policy for more income than you would get by the "dividends to reduce and balance in cash" option. To be clear, this approach is a marked departure from staying the course, both strategically and emotionally. This illustration shows no further cash outlay. But now look. You see an income stream for, in this example, 10 years. Basically, we asked the insurance company to project the maximum amount of annual income that you can take from the policy for 10 years without: (1) ever having to resume cash premiums and (2) never allowing the policy to lapse. Technically, you're surrendering paid-up additions to the extent of your basis and then taking policy loans. Under current law, the payments for the 10 years would be tax free. Let's walk through the illustration so you can understand the mechanics and, particularly, the impact of the surrenders and loans on the cash value and death benefit. There's a lot more that you'll need to understand before you choose this option, especially about the importance of monitoring the policy and calibrating how much you take out every year so that you never put the policy at risk of lapsing before you do, if you know what I mean. Just for what it's worth, newer policies can have some guardrails that mitigate the risk of the policy's lapsing, but that's not the case with a policy of this vintage.

C: This is interesting. I can definitely see why this option would be attractive for someone looking for cash flow, especially from a tax planning perspective. But, for now at least, it's not the direction that I want to take with the policy. I guess that's what you meant by "strategically or emotionally." But, you know, just seeing this option is really helpful to me. Who knows, maybe I'd do something like this in a couple years. We'll see. Meanwhile, it's another indication of how valuable the policy is and, of course, how smart I was to buy it. It's also validating my thinking about why I own the policy and what I want it to do for us.

A: I understand. I just need to show you options like this so that you can make a well-informed decision.

C: Let's stop for a minute. My coffee is IRR.

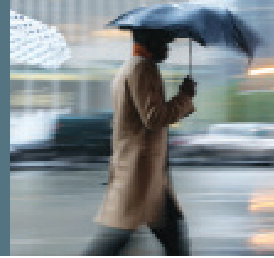
A: IRR?

C: Yeah, it's ready for refill. Can I get you some more?

A: You can't do that. It's a phone call, remember?

C: Okay, I'm back and IRR (ready to roll)! But first, I have an idea. I'm going to create a column on the far left of my notepad so that I can keep track of whether an option that you describe is something I can do at any time with no questions asked or is something that's either time sensitive or contingent on my age or health. Okay?

A: Good idea. I'll let you know as we go along. Sometimes that will be self-evident, sometimes we won't know until you apply. What's more, with the passage of time, some approaches may still be available but no longer attractive or sensible. But sure, we'll note as appropriate as we go along.



1035 Exchange

A: Okay, let's move along to a totally different discussion. As I said, this is a very nice policy. A very valuable asset. But let me show you this. Have you ever heard of a 1035 exchange?

C: Is that a street address?

A: No, the 1035 is a reference to a section of the Internal Revenue Code that allows you to exchange your policy for another one without recognizing the gain in your policy as taxable income. The reason I bring it up is that there could be some valid reasons for you to explore an exchange. For starters, if you do prioritize the death benefit for your survivors over the cash value for your own use, an exchange might enable you to apply the cash value of the current policy as premium for a new policy with a considerably larger death benefit. Assuming you don't want to pay any more premiums into any policy, we might look for the largest death benefit that would be supported for the rest of your life with either a guarantee that no further premium would be required or at least strong assurance of that result because of conservative funding assumptions. If you're willing to pay more premiums, then the new policy could support an even larger death benefit. Now, of course, whether an exchange would make sense and even be a better deal for you at life expectancy than your current policy will depend on underwriting and policy selection and design. That's why I asked if you would be willing to be examined.

C: Why wouldn't I look at that? Depending on how my thinking sorts out, that could be a good move. Can you run some numbers based on a good underwriting outcome so I can see if it's worth pursuing?

A: Sure. Let's stay on the topic of the Section 1035

TRUSTS & ESTATES
Subscribe to
Trusts & Estates
Digital
Print
Visit TrustsAndEstates.com/Subscribe

exchange, but with a different or perhaps additional objective, which is to acquire some LTC coverage. Unlike policies of yesteryear, which were one dimensional, today's policies offer features that enable you to apply the insurance towards your LTC needs. Let's just say that the policy enables you to "accelerate" the death benefit for lifetime use. A lot of people like this approach to LTC insurance, if for no other reason than it removes two of the major objections to a traditional LTC policy: (1) pricing uncertainty, and (2) paying a lot of premium but ending up never needing the policy. Again, underwriting has to cooperate.

C: I had no idea about all this! It's IRR. You know, it's really revelatory. Hey, speaking of "accelerate," if I start to run out of gas and need a break, I'll let you know.

A: Got it. Ready for another look at a Section 1035 exchange?

C: Sure.

A: You exchange the policy for an annuity. Once again, you wouldn't recognize the gain in your policy when you do the exchange. The annuity could be an immediate annuity or a deferred annuity. Now, this is a very broad topic, especially because there's been a lot of product innovation over the past few years. So in the limited time we have on this call, we'll keep things at a high level to gauge your interest. Very basically, with an immediate annuity, the cash value from the old policy buys you an income stream for the rest of your life or the rest of the joint lives of you and your spouse. The payments start within a year of the exchange. And by the way, if the concept of the immediate annuity interests you, you should know that an important feature of your own policy is the right to, basically, convert the policy into an annuity for you and, if you choose, your spouse. It's something most policyholders don't realize they can do with these policies. The insurance company can tell you how much the payments would be for each annuity option and how much of each payment would be taxable, which again, is important to you. In any event, if the concept of the immediate annuity interests you, we should explore the various kinds of products and do some comparison shopping.

> There can also be an LTC component with some deferred annuities.

C: I guess I'm like most people and didn't know that either about my policy. As far as the whole immediate annuity concept is concerned, I can understand why some people would like that idea, I mean turning the policy into an income stream that they can't outlive, especially if they don't have a pension. But I'll pass, mainly because I don't want to entirely give up the asset at this juncture. Also, I heard you say something about some of the payment being taxable, so I'd have to go through all that with my tax advisor. What about the deferred kind?

A: The deferred annuity keeps the cash value, your capital, intact, though as a client once said to me about her Section 1035 exchange of

SPOTLIGHT

Heart to Heart

La Conversation by Marcel Mouly sold for $5,355 at Doyle's Fine Art auction on Feb. 23, 2022 in New York City. A French abstract artist, Mouly is known for his boldly colored works. Ironically, Mouly was initially sent to drawing school as a punishment when he was a child. His style was influenced by some of the greats, including Matisse and Picasso (whom he counted as a friend).

a life policy to a deferred annuity, the deferred annuity "reconfigures" the cash value into a different mechanism. It does maintain the tax-deferred build-up, which you like, but you would immediately lose the life insurance in excess of the cash value. Right there, it could be a non-starter, but let's spend a couple minutes. There are different kinds of deferred annuities, and each brings something to the table. And there are a variety of options, and some rules, for taking money from the contract. There can also be an LTC component. There's even a lot of flexibility for a surviving spouse beneficiary of the contract to maintain the deferral. But this is a much longer conversation. We'd have to talk about the structure, features, benefits, charges, contractual provisions, guarantees and economics of the products and more. Of course, given your concern about taxes, we'd have to focus on the significant differences in the way the two products, meaning life insurance and deferred annuities, are taxed, both during your lifetime and on your death. And, of course, you'll want to see the numbers so that you can determine whether the overall packaging is preferable to the packaging represented by your policy.

C: Just so even I sort of understand this, let me ask you a few questions. I keep the deferral, right?

A: Right.

C: Any required minimum distributions like I have with my individual retirement account, my IRA?

A: No. There are no required minimum distributions as you have with your IRA. However, there may be a requirement that you start annuitizing at a certain age, like 90, for example. We'd have to look at each contract.

C: That, I like! Maybe it's kinda the same question, but can I choose to take money out in one year but not in another?

A: Yes, by way of withdrawals, though again, with the caveat about eventual annuitization that I mentioned.

C: That's good! When I do take a withdrawal, how is that taxed?

A: It's ordinary income to the extent of the gain you have in the contract.

C: Okay, or maybe not okay. That's good because it gives me some flexibility to manage taxable income on a yearly basis. I like that too! So, here's what I'm thinking about this. On one hand, my gut is telling me in no uncertain terms that I don't want to lose the life insurance and all the benefits and security of the policy, which I now appreciate more than I did before this phone call. On the other hand, even if I leave my policy alone after all this, give or take a tweak of the dividends, I could consider the deferred annuity for other money. I like the deferral, and I really like the absence of required distributions. So let me see some information and some numbers. I'll run this by my tax advisor too. As a matter of fact, my tax advisor does a "tax tune-up" for us after each year's return is done. I'm going to add this topic to the list!

I have to say that this is good stuff, and I'm glad you're covering it all. Hey, I have to be realistic. Things can change. Maybe a few years from now I'll need to supplement my income. Or, if my wife were to predecease me, my priorities could change, along with the rest of my life, and I'd have a very different take on what to do with the policy. So anyway, it's good to hear all this. Is there anything else I should know about?

A: Well, the last two items on my checklist are life settlements and giving the policy to charity, but neither would apply. Some day, perhaps. Meanwhile, I'll pull together some illustrations and information for the items you indicated that you would like to check out.

C: Sounds good. And thanks for making this so interesting. Very helpful!

A Rewarding Conversation

As noted earlier, this conversation would have taken a very different tack if any of C's circumstances, mindset or policy type and condition differed from C in the article. The point is that this or any C should find that a conversation like this one with a life insurance advisor has its own IRR…it's really rewarding.